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SC PUBLIC SERVICE
COMMISSION

BEFORE THE
PUBLIC SERVICE COMMISSION
OF
SOUTH CAROLINA

DIRECT TESTIMONY
OF

GARY D. SHAMBAUGH

S. C. PUBLIC SERVICE COMMISSION

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JUL 15 2004
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UTILITIES DEPARTMENT

EXECUTIVE VICE PRESIDENT
AUS CONSULTANTS - WEBER FICK & WILSON DIVISION

ON BEHALF OF

TOTAL ENVIRONMENTAL SOLUTIONS, INC.

SOUTH CAROLINA WATER AND SEWER UTILITIES

RELATIVE TO THE COMPANY'S REQUEST FOR GENERAL
INCREASES IN PUBLIC WATER AND SEWER RATES

DOCKET NO. 2004-90-W/S

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**TESTIMONY OF GARY D. SHAMBAUGH
ON BEHALF OF
TOTAL ENVIRONMENTAL SOLUTIONS, INC.**

1 Q. PLEASE STATE YOUR NAME AND BUSINESS AFFILIATION.

2 A. My name is Gary D. Shambaugh. I am the Executive Vice President of AUS
3 Consultants - Weber Fick & Wilson Division with offices located in Wormleysburg,
4 Pennsylvania and Albuquerque, New Mexico. I am also a Vice President of AUS
5 Consultants which has offices in Mt. Laurel, New Jersey, and Greenfield,
6 Wisconsin.

7

8 Q. PLEASE DESCRIBE THE SERVICES PROVIDED BY AUS CONSULTANTS.

9 A. AUS Consultants provides financial consulting services to the
10 telecommunications, electric power, natural gas transmission and distribution,
11 water, steam heat and chilled water, wastewater resource recovery, solid waste
12 disposal, and transportation industries. We also provide independent counsel to
13 governmental and regulatory bodies and numerous industrial clients.

14 Our areas of expertise include economic and financial analysis,
15 business planning, rate of return, cost of service, tariff design, rate making
16 accounting, cash working capital, assistance in raising financing, capital recovery
17 and valuation of tangible and intangible assets. AUS Consultants is a nationally
18 and internationally recognized financial consulting firm.

1 Q. MR. SHAMBAUGH HAVE YOU PREVIOUSLY TESTIFIED BEFORE THIS
2 COMMISSION?

3 A. Yes, I testified on behalf of Utilities, Inc. - Carolina Water Service's wastewater
4 operations regarding the regionalization of their I-20, Watergate and Georgetown
5 facilities and the resultant customers rates.
6

7 Q. ON WHOSE BEHALF ARE YOU TESTIFYING IN THIS PROCEEDING?

8 A. I am testifying on behalf of Total Environmental Solutions, Inc. ("TESI") or (the
9 "Company").
10

11 Q. WHAT IS THE NATURE AND SCOPE OF YOUR TESTIMONY IN THIS
12 PROCEEDING?

13 A. Total Environmental Solutions, Inc. retained AUS Consultants to prepare the
14 necessary documentation in support of their proposed requests for general
15 increases in existing Commission approved customer tariff water and sewer
16 rates. The application of Total Environmental Solutions, Inc. sets forth the results
17 of our analysis and our recommendations for proposed customer tariff water and
18 sewer rates. Supporting documents contained within the application under "Tab
19 B" entitled "Total Environmental Solutions, Inc. - South Carolina Water System"
20 contain the operating, financial and supporting data for the South Carolina Water
21 operations. Supporting documents contained within the application under "Tab
22 C" entitled "Total Environmental Solutions, Inc. - South Carolina Sewer System"

1 sets forth the relative data and information for the South Carolina Sewer
2 operations. The supporting documents for both water and sewer operations are
3 similarly styled in format and contents. TESI's rate application sets forth the
4 development of separate annual revenue requirements for the South Carolina
5 water and sewer utilities and allocates the revenue requirements to each class of
6 customer.

7 TESI's rate application is accompanied by TESI Exhibit A entitled "Total
8 Environmental Solutions, Inc. - Affiliated Services Charges Study as of December
9 31, 2002". Exhibit A sets forth the basis for the management services costs
10 allocated and/or assigned to the South Carolina water and sewer utilities.

11
12 Q: WILL YOU EXPLAIN HOW THE ANNUAL REVENUE REQUIREMENTS WERE
13 DEVELOPED FOR THE WATER AND SEWER UTILITIES?

14 A: Yes, I will. The Company has utilized an operating margin method to develop the
15 total pro forma annual water and sewer revenue requirements for the purpose of
16 this proceeding. The annual revenue requirements are comprised of the
17 following elements:

- 18 • Operating and Maintenance Expenses ("O & M")
- 19 • Annual Depreciation Expense
- 20 • Income Taxes
- 21 • Regulatory Fees
- 22 • Taxes - Other than Income

- Interest Expense, and
- Operating Margin

It is important to note that taxes - other than income, such as property taxes, are not included in the O & M expenses. The Company has claimed pro forma state and federal tax liabilities which complies with Commission practice and procedures.

Q. WILL YOU EXPLAIN EACH ELEMENT OF COST AS OUTLINED ABOVE?

A. Yes, I will.

Operating Expenses

As a result of extensive work by the Company's staff and AUS Consultants, operating costs were developed for the twelve months ended December 31, 2002. This information was compiled from general ledger accounting data and an extensive review and compilation of invoices. Adjustments were made to this information to reflect known and measurable changes and to include salaries, wages and benefits at the present cost levels. The results of our analysis is set forth in TESI's rate application in Tabs B and C for the water and sewer operations, respectively.

A summary of the per book levels and pro forma December 31, 2003 costs are as follows:

Operating Expenses12-31-0212-31-03

Water Utilities \$179,529 \$285,764

Sewer Utilities 140,039 214,108

One of the largest adjustments to the per book operating expenses at December 31, 2002 was the inclusion of affiliated charges for the water (\$28,915) and sewer (\$28,335) utilities.

Annual Depreciation Expense

The gross utility plant in service totals approximately \$2,356,697 and \$3,108,879 in capital investments in the water and sewer systems, respectively, as of December 31, 2002. TESI will be faced with the future liability of replacing the individual components of the fixed capital plant. The inclusion of annual depreciation expense in the Company's annual revenue requirement provides for a systematic recovery of plant investment based upon life expectancies of the individual asset and the recognition of the loss of capital in providing service. Annual depreciation expense will provide TESI with the necessary cash flow for fixed capital renewals and replacements and will enhance the long term financial viability of the water and sewer systems.

The previous and existing water and sewer rates established by this Commission did not include annual depreciation expense on \$5,465,576 of fixed capital investment. Thus, to date there has been little, if any, capital recovery of the utility plant in service. However, utility accounting and industry practices

1 require the assets to be depreciated based upon the original cost values when
2 first dedicated to public service. The accumulated book depreciation reserve
3 should reflect capital recovery through customer's rates. There are many
4 extenuating circumstances that have precluded the Company from compiling and
5 maintaining the proper accounting for annual depreciation expense. These
6 circumstances will be addressed later in my testimony.

7 AUS Consultants has calculated annual depreciation expense for the
8 water and sewer systems, based upon future life expectancies of the assets.
9 Based upon those life expectancies and the age of the facilities at December 31,
10 2002, the Company should have recovered \$674,460 and \$1,041,057 from water
11 and sewer rates, respectively. The net book values of the water and sewer
12 assets as of December 31, 2002 are as follows:

	<u>Net Book Value</u>
Water Utilities	\$1,682,237
Sewer Utilities	<u>2,067,522</u>
	\$3,749,759

17 AUS Consultants calculated the pro forma annual depreciation expense
18 as of December 31, 2003 by utilizing a straight line average service life
19 methodology. The average service lives employed are within industry standards
20 and are representative of the life expectancies of the assets studied.

The results of the annual depreciation expense calculations are detailed in "Tabs 2 and 3" and "Tabs B and C" in Supporting Schedule No. 6 and are summarized as follows:

	Annual Depreciation Expense <u>12-31-03</u>	Percentage Of <u>Gross Plant</u>
Water Utilities	\$42,534	1.80%
Sewer Utilities	64,988	2.09%

Q. MR. SHAMBAUGH, IS YOUR TESTIMONY THAT EVEN IF THE COMMISSION ACCEPTS THE PROPOSED ANNUAL DEPRECIATION EXPENSE CORRECTION, TESI WILL STILL HAVE TO GENERATE CASH FLOW FOR FUTURE PLANT REPLACEMENTS AT LEAST EQUAL TO THE GROSS PLANT OF APPROXIMATELY \$5.5 MILLION, BUT WILL ONLY HAVE THE OPPORTUNITY TO RECOVER APPROXIMATELY \$3.7 MILLION?

A. Yes. That is correct. TESI has assumed a tremendous financial liability with the acquisition of the South Carolina water and sewer operations. I will address those concerns at a later point in my testimony.

Q. PLEASE CONTINUE WITH YOUR DISCUSSION RELATIVE TO THE ANNUAL REVENUE REQUIREMENTS OF THE UTILITIES.

Income Taxes

The Company has claimed a pro forma liability for state and federal income for both water and sewer operations. The pro forma federal tax liabilities for the water and sewer utilities as of December 31, 2003 are inclusive of interest cost synchronizations. The annual revenue requirements associated with income taxes are as follows:

Income Taxes
12-31-03

Water Utilities \$32,866

Sewer Utilities 28,020

Regulatory Fees

The Company is required to assess their water and sewer customers regulatory fees as approved by the South Carolina Department of Health and Environmental Control. The fees are assessed on the customers bills as a surcharge and the revenues received are forwarded to the appropriate regulatory agencies. Based upon the number of water connections as of December 31, 2003 the annual revenue requirement is \$3,014.

The South Carolina Public Service Commission's annual revenue assessment is based upon the taxable revenues. Based upon the Company's pro forma revenue projections the water and sewer annual assessments will be as follows:

PSC Assessments

Water Utilities \$5,970

1 Sewer Utilities 2,805

2 In addition, Oconee County assessed the water system \$510 in fiscal
3 year 2002. For the purpose of this filing, this assessment was reflected for fiscal
4 year 2003.

5 Property Taxes

6 The property taxes amounted to \$117 for the water system and \$5,135
7 for the sewer system for the twelve months ended December 31, 2003. At the
8 time of the filing, the Company was not aware of any significant changes to the
9 claimed amounts for property taxes.

10 Interest Expense

11 The interest expense claimed in this proceeding is based upon the
12 Company's 2002 audited financial statements. The 2002 interest expense for
13 each utility is as follows:

14 2002
15 Interest Expense
16

17 Water Utilities \$7,129

18 Sewer Utilities 7,129

19 The 2003 audit is currently being finalized and the 2003 interest costs
20 relative to the South Carolina operations will be available and the Company will
21 update the rate application as this case proceeds.

Q MR. SHAMBAUGH, EARLIER IN YOUR TESTIMONY YOU INDICATED THAT THE COMPANY HAS UTILIZED AN OPERATING MARGIN METHODOLOGY IN THIS PROCEEDING. IS THAT CORRECT?

A. Yes. The Company is aware that the Commission primarily utilizes this method in determining water and sewer rates. The Company has utilized a 12.75% operating margin for both the water and sewer operations which will produce a margin of cash flow above operations as follows:

	<u>Operating Margin</u>
Water Utilities	\$55,246
Sewer Utilities	47,100

A reasonable margin of cash flow above normalized operations is necessary for the Company to provide for emergency situations, attain financial viability, and have the ability to secure long term debt at a reasonable cost rate. The utilities currently do not have the ability to secure long term debt on a stand alone basis.

Q. WHAT IS THE LEVEL OF CAPITAL INVESTMENTS MADE BY TESI AS OF DECEMBER 31, 2002?

A. TESI has invested approximately \$67,858 in the rehabilitation and repair of the water and sewer systems at December 31, 2002. The funds required to make the improvements were generated from cash flow from TESI's combined operations.

1 Q. WILL YOU PLEASE SUMMARIZE THE COMPANY'S ANNUAL REVENUE
2 REQUIREMENTS IN THIS PROCEEDING?

3 A. Yes. The Company's annual revenue requirements and the operating margin on
4 the Company's operations are set forth as follows:

	<u>Water</u>	<u>Sewer</u>
Operating Expenses	\$285,764	\$214,108
Annual Depreciation Expense	42,534	64,988
Taxes - Income	32,866	28,020
Regulatory Fees	8,984	2,805
Property Taxes & Assessments	627	5,135
Interest	7,129	7,129
Operating Margin	<u>55,246</u>	<u>47,100</u>
Total Annual Revenue Requirements	\$433,150	\$369,285

15 Q. HOW WERE THE ANNUAL REVENUE REQUIREMENTS DEVELOPED FOR
16 THE WATER AND SEWER UTILITIES FOR COST ITEMS SUCH AS
17 ADMINISTRATIVE SALARIES, WAGES AND BENEFITS?

18 A. As previously mentioned in my testimony, an extensive study was performed to
19 establish a methodology upon which the management services costs of the Baton
20 Rouge office are first allocated to each state and subsequently to the utility
21 systems obtained therein.

1 The detailed allocation methods, allocation factors and the details of the
2 2002 operating costs are set forth in Exhibit No. A.

3
4 Q. MR. SHAMBAUGH, WILL YOU SUMMARIZE THE CONTENTS OF EXHIBIT NO.
5 A AND THE RESULTS OF THE STUDY?

6 A. Yes. The Company maintains corporate offices at 1824 Ryder Drive, Baton
7 Rouge which provides administrative support and managerial functions to utilities
8 owned in six (6) states. The services provided would include, but not limited to,
9 customer service, customer billing and collection, financial management and
10 accounting and a consolidated management base to provide the best possible
11 service to TESI's customers.

12 The costs of the management operations can be categorized into four
13 (4) major components as follows:

- 14 • Operating Costs,
- 15 • Facilities Costs,
- 16 • Parent Company Costs,
- 17 • Contract Services

18 The total affiliated charges as contained in Exhibit A amounts to
19 \$1,469,901 which are relative to fiscal year 2002 operations. Of this amount
20 approximately \$57,250 was allocated to the South Carolina water and sewer
21 operations.

1 Q. MR. SHAMBAUGH, DID YOU COMPARE THE RESULTS OF YOUR STUDY
2 CONTAINED IN EXHIBIT A WITH UTILITY INDUSTRY EXPERIENCE OR
3 CURRENT MARKET GUIDELINES TO TEST THE REASONABLENESS OF
4 THE CHARGES?

5 A. Yes. The results of those comparisons demonstrate that the overall management
6 costs are at or below industry experience.
7

8 Q. MR. SHAMBAUGH DID YOU PERFORM A FULLY ALLOCATED COST OF
9 SERVICE STUDY FOR THE SOUTH CAROLINA WATER AND SEWER
10 OPERATIONS?

11 A. No. For the purpose of this proceeding, AUS Consultants determined that the
12 preparation of a fully allocated cost of service study for rate design purposes
13 would not be cost beneficial. The customer base for the water and sewer
14 operations is predominately residential. A reasonably accurate customer tariff
15 rate design can be performed for both water and sewer operations absent a fully
16 allocated cost of service study.
17

18 Q. MR. SHAMBAUGH, WHAT IS THE COMPANY PROPOSING WITH REGARD
19 TO CUSTOMER TARIFF RATE DESIGNS?

20 A. The Company is proposing uniform water and sewer rates by customer class.
21 Those rates and proof of revenues are set forth in Tab B and Tab C Supporting
22 Schedule 9 for the water and sewer utilities, respectively.

1

2 Q. IS IT IMPORTANT TO HAVE UNIFORM RATES BY CUSTOMER CLASS?

3 A. Yes. Uniform rates by customer class is the first step in avoiding rate
4 discrimination within a class.

5

6 Q. WHAT WILL BE THE TYPICAL MONTHLY BILL FOR RESIDENTIAL WATER
7 SERVICE AT THE PROPOSED RATES?

8 A. A typical residential customer will experience a monthly bill of \$62.55.

9

10 Q. WHAT WILL BE THE TYPICAL MONTHLY BILL FOR RESIDENTIAL SEWER
11 SERVICE AT THE PROPOSED RATES?

12 A. A residential sewer customer will experience a monthly flat rate bill of \$55.66 at
13 the proposed rates.

14

15 Q. DO YOU CONSIDER THE PROPOSED WATER AND SEWER CUSTOMER
16 RATES AS SET FORTH IN THE COMPANY'S RATE APPLICATION TO BE
17 FAIR, JUST AND REASONABLE?

18 A. Yes.

19

20 Q. MR. SHAMBAUGH, EARLIER IN YOUR TESTIMONY YOU REFERENCED
21 APPROXIMATELY \$5.5 MILLION OF FIXED CAPITAL ASSETS. WAS THE

1 COMMISSION PREVIOUSLY AWARE THAT THESE ASSETS WERE
2 CAPITALIZED ON THE BOOKS OF THE WATER AND SEWER SYSTEMS?

3 A. Yes. One of the previous owners, National American Corporation ("NACO")
4 capitalized approximately \$4,477,462 in water and sewer assets. NACO then,
5 without explanation, removed the assets from the balance sheet in 1991 and
6 1992 just prior to the utilities sale to Johnson Properties, Inc. In 1994.

7
8 Q. DID NACO REMOVE ASSETS FROM THEIR OPERATIONS IN OTHER
9 STATES?

10 A. Yes. The same unsupportable balance sheet adjustments were made in
11 Pennsylvania, North Carolina and Tennessee. The Pennsylvania Public Utility
12 Commission has subsequently reversed the adjustments and restated the fixed
13 capital assets. TESI has not approached North Carolina or Tennessee due to
14 rate case timing and planning for those states.

15
16
17 Q. WAS THE 1994 SALE TO JOHNSON PROPERTIES, INC. ("JPI") A STOCK
18 TRANSACTION?

19 A. Yes. The stock sale would have no bearing on the asset values. Thus, I have
20 concluded that the asset removal from the balance sheet had no direct
21 relationship to the sale to Johnson Properties, Inc.

1 Q. WOULD THE ASSET REMOVAL PROVIDE ANY FINANCIAL OR
2 REGULATORY ADVANTAGES TO EITHER THE BUYER OR THE SELLER?

3 A. No.
4

5 Q. HOW DOES THE COMPANY PROPOSE TO CORRECT THIS INJUSTICE?

6 A. The surviving original assets as of December 31, 1992 were returned to the
7 balance sheet at the original costs when first dedicated to public service. In
8 addition, JPI installed water and sewer lines in certain sections within the
9 Foxwood Hills Development in the mid to late 1990's. Those assets have been
10 included to arrive at the gross water and sewer assets as follows:
11

12 Water \$2,407,548

13 Sewer \$3,127,589
14

15 Q. TO YOUR KNOWLEDGE, HAVE THE CUSTOMERS PAID FOR ANY OF THE
16 ASSETS CLAIMED BY THE COMPANY IN THIS RATE APPLICATION?

17 A. No. The Company has not recovered any funds through customers rates related
18 to annual depreciation expense.
19

20 Q. HAVE THE CUSTOMERS BENEFITTED FROM \$0 ANNUAL DEPRECIATION
21 EXPENSE AS A COMPONENT OF THE COMPANY'S ANNUAL REVENUE
22 REQUIREMENTS?

1 A. No. The lack of capital recovery and cash flow related to the fixed capital assets
2 has resulted in years of deferred maintenance and a deteriorating level of service
3 prior to TESI's acquisition.
4

5 Q. WHY IS IT IMPORTANT FOR THIS COMMISSION TO RECOGNIZE THE FIXED
6 CAPITAL ASSETS ON THE COMPANY'S BALANCE SHEET?

7 A. There are several interrelated financial considerations which will ultimately benefit
8 the customers.
9

10 Q. WOULD YOU PLEASE EXPLAIN?

11 A. Yes. It is important for this Commission to correct the fabricated adjustments to
12 the fixed capital assets so that the Company will reflect the capital it will be
13 required to replace in the future. While the current balance sheet will reflect \$0 in
14 pre-acquisition assets, in reality the Company will be faced with the future liability
15 (\$5.5 million) of the replacement of those assets. Without some type of rate
16 recognition the Company will have no internal or external sources to generate the
17 funds necessary to replace the plant.
18

19 Q. UNDER THIS SCENARIO, WOULD THE COMPANY BE CONSIDERED A
20 FINANCIALLY NON-VIABLE ENTITY?

21 A. Yes. The only way the utilities could survive is to be subsidized by the
22 Company's operations in other states.

1 Q. WILL YOU PLEASE CONTINUE?

2 A. Yes. The lack of cash flow from annual depreciation expense or return on
3 investment sends a very negative signal to potential lenders. Without any cash
4 flow generated from the embedded assets any new plant placed in service is at
5 risk due to insufficient rates. Lenders will not be receptive to loaning the
6 Company money for plant upgrades, additional capacity, customer meters, etc.,
7 without guarantees or assurances from TESI's parent company or their
8 operations in the other states. The South Carolina utility operations would not be
9 self sufficient, nor financially independent, and would be forced to rely upon
10 others for financial assurances or guarantees.

11 In addition, the future liabilities will have a serious impact on TESI's
12 consolidated balance sheet, a negative impact on the remaining operations, and
13 impede TESI's goals for long term debt financing and restructuring.

14
15 Q. MR. SHAMBAUGH, HOW WILL THE CUSTOMERS BENEFIT BY INCLUDING
16 ANNUAL DEPRECIATION EXPENSE AS A PART OF THE COMPANY'S
17 ANNUAL REVENUE REQUIREMENT?

18 A. It must be recognized that annual depreciation expense is a cost of providing
19 service just like purchased water, purchased power, bad debt expense, etc. The
20 recovery of an operating expense, (annual depreciation expense) will provide the
21 Company with internally generated cash to meet long term debt obligations and
22 fund some of the future plant renewals and replacements. This may, in turn,

1 allow the Company to mitigate future interest costs and thus control rate
2 increases. Developing a sound financial profile for the South Carolina utilities will
3 assist in long term financing at favorable rates. Future customer's rates would
4 benefit from stable and financially independent South Carolina operations.

5
6 Q. IS THE COMPANY REQUESTING A RETURN ON THE FIXED CAPITAL
7 ASSETS FILED IN THIS PROCEEDING?

8 A. No.
9

10 Q. BASED UPON THE FINANCIAL CONDITION OF THE SOUTH CAROLINA
11 UTILITIES AND WITH THE PROSPECT OF CONSIDERABLE FUNDS
12 REQUIRED TO UPGRADE THE FACILITIES, WHY DID TESI PURCHASE THE
13 UTILITIES IN FOXWOOD HILLS?

14 A. TESI was created by the South Louisiana Electric Cooperative Association to
15 solve very serious environmental and customer service related problems of water
16 and sewer systems throughout Louisiana and Mississippi. The South Carolina
17 utilities were part of the package Louisiana bankruptcy sale. SLECA's number
18 one operational objective is to provide safe and quality service to their customers.
19 TESI has copied SLECA's management goals and cooperative objectives.

20 TESI has requested this Commission to adopt a financial model which
21 will provide the necessary funds for present and future operations. Should TESI
22 not be successful in obtaining the funds necessary to establish the South

1 Carolina utilities as financially viable entities, alternative courses of action will
2 have to be considered.
3

4 Q. MR. SHAMBAUGH, UNDER THOSE CIRCUMSTANCES, WHAT WOULD BE
5 YOUR RECOMMENDATIONS TO TESI'S MANAGEMENT AND ITS BOARD OF
6 DIRECTORS?

7 A. I would recommend that TESI cease all short term and long term capital projects
8 and promptly seek potential buyers for these utilities. TESI cannot afford to
9 jeopardize the investments made in other states or subsidize operations in South
10 Carolina. In my opinion, the South Carolina utilities will be destined to fail.
11

12 Q. MR. SHAMBAUGH, WOULD TESI'S SOUTH CAROLINA OPERATIONS BE
13 COMPARABLE TO OTHER SOUTH CAROLINA WATER AND SEWER
14 SYSTEMS?

15 A. No. With over 73 miles of water and sewer mains the gross plant investment
16 exceeds \$5,000 per customer. The true cost of service including annual
17 depreciation expense, produces water and sewer rates that can be categorized
18 as some of the highest cost of operations in the state.

19 The higher than normal proposed rates are primarily related to the level
20 of infrastructure required to provide service and the number and density of the
21 customer base.
22

1 Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY AT THIS TIME?

2 A. Yes.

3

4

5

6

7